

Leveraged ESOP; unrelated income; debt-financed securities. Employer securities purchased with borrowed funds by a qualified trust forming part of a leveraged employee stock ownership plan that satisfies the requirements of section 4975(e)(7) of the Code are not debt-financed property within the meaning of section 514(b), and dividends and interest earned on such securities are not unrelated business taxable income to the trust; Rev. Ruls. 71-311 and 74-197 distinguished.

Advice has been requested whether 'unrelated business taxable income' within the meaning of section 512 of the Internal Revenue Code of 1954 results from the payment of dividends or interest on employer securities purchased with funds borrowed by a trust forming part of a leveraged employee stock ownership plan (ESOP) that satisfies the requirements of sections 401(a) and 4975(e)(7) of the Code.

Section 511(a) of the Code imposes a tax on the unrelated business taxable income (as defined in section 512) of every organization described in sections 401(a) and 501(a) and certain other organizations. Section 512(a)(1) defines the term 'unrelated business taxable income' as the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by Chapter 1 of the Code which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b)(1) of the Code excludes from the term 'unrelated business taxable income' all dividends, interest, and annuities, and all deductions directly connected with such income. However, section 512(b)(4) provides that, notwithstanding these exclusions, in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1) (relating to the percentage of the income from debt-financed property that is taken into account), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2) (relating to the percentage of deductions taken into account with respect to debt-financed property).

Section 514(b)(1) of the Code defines 'debt-financed property' as any property that is held to produce income and with respect to which there is an acquisition indebtedness (as defined in section 514(c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition). Section 514(c) provides in part that 'acquisition indebtedness' means with respect to any debt-financed property, the unpaid amount of the indebtedness incurred by the

organization in acquiring, or improving such property. However, section 514(c)(4) provides that the term 'acquisition indebtedness' does not include indebtedness the incurrence of which is inherent in the performance or exercise of the purpose of function constituting the basis of the organization's exemption. Furthermore, section 514(b)(1)(A)(i) excludes from debt-financed property any property substantially all the use of which is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501. Section 1.514(b)-1(b)(1)(i) of the Income Tax Regulations refers to section 1.513-1 for principles applicable in determining whether there is a substantial relationship to the exempt purpose of the organization.

Section 1.513-1(d)(2) of the regulations states that a trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is 'substantially related,' for purposes of section 513, only if the causal relationship is a substantial one.

Rev. Rul. 71-311, 1971-2, C.B. 184, explains that an employees' trust forming part of a plan qualified under section 401(a) of the Code is subject to tax on unrelated business taxable income under section 511 and, in this connection, refers to sections 512(b)(4) and 514, regarding the inclusion of certain debt-financed income in unrelated business taxable income.

Rev. Rul. 74-197, 1974-1 C.B. 143, explains that the exceptions contained in either section 514(b)(1)(A)(i) of the Code or section 514(c)(4) do not apply to investment borrowing of an exempt employees pension trust that is maintained for the purpose of paying definitely determinable benefits to its participants or their beneficiaries, as described in section 1.401-1(a)(2)(i) of the regulations. Because the purpose of such a trust is to receive the contributions of the employer, the employees or both, and to use the contributions and increments thereon to provide pension benefits to the employee participants at retirement, the indebtedness was an acquisition indebtedness as defined in section 514(c) and the property acquired with the borrowed funds is not substantially related (aside from the need of the trust for funds) to the exercise or performance by the trust of its exempt purpose or function. Accordingly, the exempt trust's investment activity could result in unrelated business taxable income within the meaning of section 512.

Section 4975(e)(7) of the Code provides that the term 'leveraged employee stock ownership plan' means a defined contribution plan (A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed

to invest primarily in qualifying employer securities; and (B) which is otherwise defined in regulations prescribed by the Secretary or his delegate Under a leveraged ESOP an employee stock ownership trust generally acquires stock of the employer with the proceeds of a loan made to it by a financial institution. Frequently, the loan is guaranteed by the employer. The employer's contributions to the employees' trust are applied to retire the loan.

An ESOP is a technique of corporate finance designed to build beneficial equity ownership of shares in the employer corporation into its employees substantially in proportion to their relative income without requiring any cash outlay on their part, any reduction in pay or other employee benefits, or the surrender of any rights on the part of the employees. S. Rep. No. 94-938, 1976-3 C.B. (Vol. 3) 49, 218. Congress intended to encourage ESOP's as a method of strengthening the free private enterprise system that would solve the dual problems of securing capital funds for necessary capital growth and of bringing about stock ownership by all corporate employees. The Tax Reform Act of 1976, section 803(h), 1976-3 C.B. (Vol. 1) 1, 66. Therefore, a leveraged ESOP's capital growth and stock ownership objectives are to be considered part of its exempt function under section 401(a) of the Code and borrowing to purchase employer securities is an integral part of accomplishing these objectives.

Because the indebtedness incurred by a leveraged ESOP to purchase employer securities is inherent in the performance or exercise of the purpose or function constituting the basis of the ESOP's exemption, such borrowing is not 'acquisition indebtedness' within the meaning of section 514(c) of the Code. Furthermore, the employer securities that are purchased by a leveraged ESOP are substantially related to the exercise or performance by the ESOP of the purpose of function constituting the basis of the ESOP's exemption as described in section 514(b) (1) (A) (i).

Accordingly, the employer securities purchased by a leveraged ESOP with borrowed funds are not 'debt-financed property' within the meaning of section 541(b) of the Code and the dividends and interest thereon will not be 'unrelated business taxable income' within the meaning of section 512. This situation is distinguishable from a situation in which a pension or profit sharing plan that satisfies the requirements of section 401(a) borrows money to purchase securities of the employer; in the latter situation the exempt trusts' borrowing to purchase employer securities could result in unrelated business taxable income within the meaning of section 512.

Rev. Rul. 71-311 and Rev. Rul. 74-197 are distinguished.